

Indian Asset Management: Achieving Broad-based Growth





Executive Summary

India has a strong and rapidly growing asset management industry, growing faster than those of developed economies such as the US and the UK and emerging markets such as Brazil. Although young, the industry shows signs of early maturity, and growth opportunities abound in most segments.

THE STORY SO FAR: HIGH GROWTH AND PROFITABILITY IN A YOUNG INDUSTRY

The Indian asset management industry has grown at a rapid 47 per cent year-on-year since 2003, reaching total assets under management (AUM) of over US\$92 billion in March 2007. This growth has outpaced that in most economies such as the US, the UK and Brazil, whose asset management industries grew at 13 per cent, 29 per cent, and 44 per cent respectively in the same timeframe. Only Russia and China outpaced India during these years, with AUM growth rates of 97 per cent and 67 per cent respectively.

The Indian mutual funds industry is more profitable than those in other countries: industry operating profit, as a percentage of average AUM, is 32 bps in India compared to 12 bps in the UK and 18 bps in the US. Notably, this is the case despite a higher cost structure than that in most economies.

Mutual funds investment in India continues to be low across both retail and institutional segments: AUM, as a percentage of GDP, are pegged at 8 per cent, compared to 79 per cent in the US and 39 per cent in Brazil. Penetration of households for investment in mutual funds is 3 to 4 per cent, with a penetration of less than 15 per cent in the top 8 cities. Among households penetrated, the top 8 cities account for 75 per cent of retail AUM. In the institutional segment, large corporations and mid-sized corporations account for more than 50 per cent of AUM, followed by small and medium enterprises (SMEs) and banks. Insurance companies and pension funds contribute limited amounts.

New equity inflows have contributed more than half the growth of the mutual funds industry in India, while appreciation in the value of existing assets accounts for the rest. They were evenly divided between new fund offers (NFOs) and running schemes in 2007. In mature markets such as the US, NFOs contribute just over 10 per cent of the new inflows.

Retail and portfolio management schemes (PMS) currently account for more than 85 per cent of industry revenues and nearly all profits, with the institutional business primarily a driver of volumes and league table positions. Within retail, profitability in the top 8 cities is much higher than in the next tiers (tier 2 and 3) mainly due to higher per-ticket investments, higher channel productivity and a lower cost of acquisition. The top 8 cities account for more than 90 per cent of industry retail profits today.

OPPORTUNITY FOR BROAD-BASED GROWTH

Strong growth is on the cards for all segments, with retail investment growing the fastest and the institutional segment following closely behind. Portfolio management could soon start coming into its own.

The retail segment will be the largest contributor to the growth of the asset management industry in India and is expected to grow at a CAGR between 35 to 42 per cent in the next five years. Growth is expected to be broad-based, driven by high net-worth individuals (HNI) and the mass-affluent segment in the top 8 cities and by further penetration in the next tier towns. Over the next five years, the mutual funds industry could see the addition of nearly 9 million first-time retail customers. Plain vanilla products must continue to be a focus to serve this customer segment; even in mature markets, traditional products contribute over 75 per cent of AUM.

The institutional segment is expected to grow at a rate of 25 to 33 per cent per year for the next five years. Large corporates will continue to dominate this segment, contributing over 50 per cent of institutional AUM. Regulatory flexibility coupled with the recently visible, more favourable mindset towards investing in mutual funds could add significant AUM from public-sector undertakings (PSUs) and pension funds. Currently, PSUs with an investible surplus of US\$70 billion can invest 30 per cent of the corpus in public sector-run equity-focused mutual funds. Raising this limit and introducing products targeted towards PSUs will spur growth.

Moreover, the institutional segment will further expand if retirement schemes with funds under the employees' provident fund (EPF) and old central and state government schemes—which held US\$106 billion in 2005–06—are also allowed

to invest. The New Pension Scheme (with an expected incremental corpus worth US\$250 million yearly) and the pool of non-government pension funds, which are now allowed to invest 10 per cent of their corpus in equity-oriented mutual funds, will provide a further impetus to the growth of institutional AUM. The outsourcing of funds management by insurance companies, with funds under management of US\$10 billion by private sector insurance companies, and other retirement funds will create a further opportunity for asset management companies (AMCs).

Another big driver of revenues for AMCs in India is portfolio management services (PMS), which could contribute more than 20 per cent of total revenue by 2011. Asset management companies will, however, have to find adequate fund management talent to drive PMS growth.

Overall, India is starting to distinguish itself from other emerging market economies as an investment prospect, with India-focused mutual funds generating over US\$80 billion in AUM over the last five years.

We expect profitability to be driven by retail and PMS over the next few years. Within retail we expect profitability of the next tier to improve given increasing affluence, higher awareness of mutual funds due to a supply push and improving channel productivity. The contribution of the institutional segment to profitability depends on the extent of regulatory change, as described above.

WHAT IT WILL TAKE TO WIN

Distribution and branding will make the difference between winners and the rest, and fund performance will be the ticket to play. The market will see the evolution of players into at-scale, asset class-focused or multi-boutique players. Large domestic players and new entrants, who will find greenfield economics relatively attractive, will increase the competitive intensity.

Distribution: The prime driver of growth

Revenue pools are skewed in favour of distributors, who corner almost 60 per cent of revenue, with manufacturers accounting for the rest. Customers choose an AMC primarily on the recommendation of a salesperson, followed by fund performance and brand strength.

Given that distribution in India has already leapfrogged to an open architecture, with banks, independent financial advisors (IFAs) and national distributors (NDs) playing an almost equally important role, it is imperative for AMCs to manage distribution partners with care.

Banks are the dominant channels in the top 8 cities. Even here, however, the cross-sell rates for banks, at an average of 2 per cent in urban India, are much lower than global benchmarks (e.g., 12 per cent in the UK and 15 per cent in Belgium). Only foreign banks in India are closer to global benchmarks, with a cross-sell rate of about 8 per cent. National distributors today offer better services than banks and IFAs, especially in investor query resolution, and are primarily focused on HNI and affluent customers. Independent financial advisors come across as the most preferred primary channel for distribution beyond the top 8 cities.

Branding: The key to influencing the perception of performance

Fund performance is a necessary but not sufficient condition for driving AUM growth. Funds in the top decile (with respect to historic growth) have witnessed maximum growth across asset classes, from pure equity to pure debt products, and across time. However, among different funds, growth varies significantly for top-performing schemes. Our research shows that a positive perception of the brand induces a positive view of performance, even if the figures don't bear this out. Strong brands are able to influence perception of fund performance and hence spur growth, making brand management one of the critical success factors in the industry.

We expect players to differentiate themselves on the dimensions of strategy and focus and that winners will be those making an explicit choice among the three strategies—at-scale players, asset class-focused players, and multi-boutique players.

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As economic growth in India swells wallets and regulators ease the reins to further encourage growth, AMCs in India will prosper, provided they heed and develop the market. Regulatory changes, within and outside the asset management industry will have a material role in shaping evolution. With the right actions by players and regulators, India can look forward to a vibrant asset management industry, enriching both investors and players.